Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:NJD:NEW:TL-N-1660-99
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date: APR 19 1999

to: Chief, Examination Division, New Jersey District

from: District Counsel, New Jersey District, Newark

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subject: [redacted] - Section 482
U.I.L. Nos. 7605.01-00, 0482.25-00

This responds to your request for advice regarding whether the taxable years [redacted], [redacted], [redacted] and [redacted] for [redacted] can be reopened for examination.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

FACTS:

The taxable years [redacted] and [redacted] of [redacted] were subject to examination by I.E. for the possibility of a section 482 pricing adjustment. After examination of the [redacted] and [redacted] taxable years, I.R.S. economist, Walter Leibowitz, recommended that a section 482 adjustment should not be made. Accordingly, the examination was closed "no change". Taxable years [redacted] and [redacted] were examined domestically for unrelated issues and were also closed "no-change". The current cycle,

taxable years [redacted], is under examination for a potential section 482 adjustment. The taxpayer reported a loss in each of the taxable years. The losses are the result of NOLs carried forward from the previously examined years. I.R.S. economist, William Oyster, believes that if the [redacted], [redacted], [redacted] and [redacted] taxable years are reexamined there may be a basis for a section 482 adjustment in each year which would eliminate the NOLs carried forward.

ISSUES:
1) Whether the statute of limitations bars adjusting the NOLs which arose in the closed years and are carried forward to the open years?
No. The earlier years closed by statute can be examined for the limited purpose of eliminating the NOLs carried forward to the open years under examination.

2) Whether the previously examined years can be reexamined for possible pricing adjustments?
While there is no legal prohibition on reexamining such years, I.R.S. policy would allow such reexamination only if a good faith determination is made that failure to reopen would be a serious administrative omission.

3) The following concerns were expressed regarding a potential request by the taxpayer for competent authority consideration:
Would such years receive competent authority consideration?
Probably not.
Would the issues automatically be conceded due to the age of the tax years?
No.
Would there be double taxation due to no competent authority involvement?
Probably yes.

1. Statute of Limitations.

It is clear that the statute of limitations does not bar examining the earlier closed years for the purpose of eliminating or adjusting the NOLs arising in such years and carried forward to the open years currently under examination.

2) Reopening Issue

We will examine this issue from both the consideration of (a.) I.R.C. section 7605(b) and (b.) I.R.S. policy concerning reopening.

(a.) I.R.C. Section 7605(b) provides, "[n]o taxpayer shall be

subject to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing than an additional inspection is necessary." The purpose of the restriction is to shift the discretion for a reexamination of the taxpayer's books to higher personnel from the field agent. United States v. Powell, 379 U.S. 48, 54-55 (1964).

The legislative history of Section 7605(b) clarifies what is meant by an "unnecessary" examination. The section was enacted to restrict the service from undertaking repetitive investigations as a method of taxpayer harassment. Collins v. Commissioner, 61 T.C. 693 (1974). There is no indication that section 7605(b) was enacted to restrict the scope of the commissioner's legitimate power to protect the revenue. Id., citing, H. Rept. No. 350, 67th Cong., 1st Sess., p. 16 (1921); S. Rept. No. 275, 67th Cong., 1st Sess., p. 31. An investigation is not "unnecessary" if it may contribute to the accomplishment of any of the purposes for which the Commissioner is authorized by statute to make inquiry. Id. In the absence of a showing that the Commissioner acted arbitrarily or in excess of statutory authority an investigation is not unnecessary. Id.; See U.S. v. Powell, 379 U.S. 48 (1964)(Showing of probable cause of fraud is not required prior to examination). Furthermore, the Internal Revenue Service may investigate merely on the suspicion that taxes are owed. Id.

Section 7605(b) only applies where an additional examination of the taxpayer's books of account is required. Where a deficiency is based on the taxpayer's return and information already provided by the taxpayer in a previous examination, there is no second inspection of the taxpayer's books of account within the meaning of section 7605(b) and written notice is not required. See Feldman v. Commissioner, 49 TCM 1012 (1985).

In addition to the requirements of section 7605(b), the Service has its own internal reopening procedures. IRM 4023.6 provides the following guidelines in requesting approval to reopen a closed case:

> (1) All Service initiated reopenings to make adjustments unfavorable to the taxpayer must be approved by the Chief, Examination Division (District Director in districts where there are no division chiefs), or Chief, Compliance Division, for cases under his/her jurisdiction.
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> (2) At the district or service center level examiners

usually will initiate requests for approval to reopen a closed examined case. Initiators will prepare Form 4505 (a four-part assembly) and forward it to first level of approval. The administrative file need not accompany the request.

(3) The normal routing of requests for reopening initiated at the district level, whether or not an additional inspection of the taxpayer's books of account is required, follows: 1) Initiator retains part 4; forwards parts 1,2 and 3 to Group Manager. 2) Group Manager forwards all three parts to Branch Chief. 3) Chief, Field (Office) Examination Branch forwards all three parts to Chief, Examination Division. 4) Chief, Examination Division returns part 1 to the initiator, using the route followed for approval. Part 2 is forwarded to ARC (Examination) at the region's option. Part 3 is retained.

(b.) The Service's policy is not to reopen a closed case to make an adjustment unfavorable to the taxpayer unless (1) there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of material fact; (2) the prior closing involved a clearly defined substantial error based on an established Service position existing at the time of the previous examination; or (3) other circumstances exist that indicate that failure to reopen would be a serious administrative omission. See Rev. Proc. 94-68, 1994-2 C.B. 803, Sec. 5.01.

"Serious administrative omission" includes situations in which failure to reopen closed cases could: a)result in serious criticism of the Service's administration of the tax laws; b) establish a precedent that would seriously hamper subsequent attempts by the Service to take corrective action; and c) result in inconsistent treatment of similarly situated taxpayers who have relatively free access as to how the service treated items on other taxpayer's returns. IRM 4023.5:(1).

"Clearly defined" means that the error is clearly apparent as opposed to being vague or uncertain. IRM 4023.5:(2)(a). "Substantial" refers to the dollar amount of tax that would not be assessed if the case was not reopened. IRM 4023.5:(2)(b). A case may be reopened with less than complete surety as to the amount of additional tax that may be assessed. IRM 4023.5:(2)(b). However, the following guidelines should be utilized: i. Any proposed change to a case involving net additional tax totaling $10,000 or more is normally regarded as substantial; ii. any proposed change to a case involving net additional tax totaling

$1,000 or less is not substantial. IRM 4023.5:(2)(b)(1). "Based on an established Service position at the time of the previous examination" requires that the service position must have been clear at the time of the previous examination and not in a developing stage. IRM 4023.5:(2)(c). The "substantial error" criterion is not considered for reopening if either of the other two criteria are present. IRM 4023.5:(2)(d).

Analysis:

(a) I.R.C. section 7605(b)

Consistent with section 7605(b), [redacted] will have to be notified in writing if a second examination of its books and records is undertaken. We believe a second examination is not "unnecessary" based on the economist and revenue agent's opinion that there may be a basis for a section 482 adjustment. Thus, we do not believe I.R.C. section 7605(b) would preclude the second examination.[1] However, since it was determined in the prior examination that a section 482 adjustment should not be made, it would be helpful if a different basis for an adjustment could be utilized.[2] This could alleviate the problem of the taxpayer arguing that the examination is unnecessary and is being conducted for harassment purposes. Unlike the I.R.S. reopening procedures, failure to comply with section 7605(b) may preclude summons enforcement. See U.S. v. Garrison Construction Co.,77-1 USTC § 9705, (The U.S. District Court precluded an examination of the taxpayer's books and records where the revenue agent failed to provide written notice to the taxpayer that a second examination was necessary).

(b) I.R.S. Policy.

The Service's reopening procedures are merely directory, not mandatory. Collins v. Commissioner, 61 T.C. 693 (1974)(Compliance

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[1]In the event that the taxpayer's books and records do not need to be reexamined and all necessary documents for proposing a section 482 adjustment are in the possession of the Service, then section 7605(b) does not apply.

[2]We inquired into whether an adjustment was considered under section 163j. The agent indicated that section 163j was considered for the current year and it was concluded that there was no basis for the adjustment. Section 163j was not in effect for the [redacted] and [redacted] taxable years, but was in effect for the [redacted] and [redacted] taxable years with the exception of the provisions pertaining to "disqualified guarantees". The revenue agent (I.E.) does not believe that there is a basis for a section 163j adjustment in [redacted] and [redacted].

with I.R.S. procedural rules is not essential to the validity of a notice of deficiency). However, the Service should always abide by its internal rules. The determination of whether the procedural requirements for reopening are met is within the jurisdiction of the examination division.

We should note that the first and second basis for reopening (ie. fraud, etc. or "clearly defined substantial error") do not seem to apply. Therefore, the only basis for reopening would be a determination of a "serious administrative omission". This is a facts and circumstances determination. Some of the factors to consider are:

i. The taxpayer may have already disposed of pertinent records based on the "no change" and would therefore be prejudiced by a reopening.

ii. The new section 482 proposal should be based upon a methodology which was not considered by or was wrongly considered by the prior economist (not just a new look at the same facts and methodologies).

iii. Since the old regulations applied to the earlier years and a strict ordering rule was applicable, we must be able to show our new methodology can properly be applied (ie. higher priority methods cannot be used under the applicable facts).

iv. (b)(7)e [redacted]

v. Any adjustments would probably result in double taxation (see competent authority discussion below).

(b)(7)a, (b)(7)e [redacted]

3. Competent Authority Issue.

A section 482 adjustment for the [redacted], [redacted], [redacted] and [redacted] taxable years due to sales transactions with its Japanese parent would result in the shifting of income to [redacted]. [redacted]'s parent probably reported and paid tax on this income. It is anticipated that [redacted] will request competent authority relief from double taxation when the section 482 adjustment is proposed. Since the statute of limitations in Japan is closed, concern has been expressed regarding the result of the competent authority request.

Rule/Analysis

Article 25 [Claims of Double Taxation] of the U.S.-Japan Tax Treaty, provides that a taxpayer may obtain relief from double taxation by making a claim to the "competent authority" of their Contracting State. A goal of United States Competent Authorities ("USCA") is to obtain a correlative adjustment from the treaty country with respect to a U.S. initiated adjustments under section 482. See Rev. Proc. 96-13, 1996-1 C.B. 616, sec. 12.07. The taxpayer may make a claim "notwithstanding the remedies provided by the national laws of the Contracting States". Japan - United States Income Tax Treaty, July 9, 1972, art. 25(1). Therefore, a taxpayer may request relief even if the taxable years are closed by statute.

When a section 482 adjustment is proposed on an U.S. taxpayer, the taxpayer is notified and appraised of the right to request competent authority relief. IRM 42(10)(12).7(4)(a). Once a claim is made, the USCA determines if the claim has merit and should be considered. Japan - United States Income Tax Treaty, July 9, 1972, art. 25(1). If the claim is determined to have merit and is accepted for consideration, the USCA "shall endeavor to come to an agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation contrary to the provisions of this Convention". Id.

If the USCA accepts a request, he may modify or concede the adjustment based on negotiations with Japan's competent authority. Japan - United States Income Tax Treaty, July 9, 1972, art. 25(4). Although the goal of the competent authority process is to avoid double taxation, the USCA will not withdraw or reduce an adjustment solely because the period of limitations has expired in the foreign country and the foreign competent authority has declined to grant relief. Rev. Proc. 96-13, 1996-1 C.B. 616, sec. 12.07. However, "[i]f the period provided by the foreign statute of limitations has expired, the U.S. competent

authority may take into account other relevant facts to determine whether such withdrawal or reduction is appropriate and may, in extraordinary circumstances and as a matter of discretion, provide such relief with respect to the adjustments to avoid actual or economic double taxation." Id.

(b)(5)(DP), (b)(7)a, (b)(7)e

[redacted]

If you have any questions please contact attorney Anthony Ammirato at (973)645-2539 or attorney Clare W. Darcy. Please note that the advice is being sent to our National Office for post-review.

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